

Report on the Audit of the Board's Financial Examination Program (A9107)

The Federal Reserve Act requires the Board to examine the accounts, books, and affairs of the twelve Reserve Banks. The financial examination program, which *is organizationally located in* DRBOPS, carries out this mandate by conducting financial examinations at the Reserve Banks throughout the year. One of the key objectives of these examinations is to verify the accuracy and reliability of a Reserve Bank's balance sheet in accordance with generally accepted auditing standards (GAAS).

We found that the program is making positive contributions in its examinations of the Reserve Banks, particularly in its review of internal controls and propriety of expenditures. However, we believe that major revisions are needed to the timing, scope, and methodology of the program and make eighteen recommendations to help the program achieve full compliance with audit standards and to improve its economy, efficiency, and effectiveness. The two most significant recommendations focus on the issue of independence and audit standards. To comply with GAAS, an audit organization and the individual auditors must be free from personal and external impairments to independence and maintain an independent attitude and appearance. Because DRBOPS also performs other management oversight functions for the Reserve Banks, we concluded that the current organizational placement of the financial examination program within DRBOPS could result in a perceived lack of financial independence which would prevent the Board from fully complying with GAAS. As a result, we recommended that the Board (1) make the financial examination program organizationally independent from DRBOPS and have the program report directly to the Board and (2) have the program follow generally accepted government auditing standards (GAGAS), which incorporate key aspects of GAAS and allow an organization's auditors to be considered independent if they report to the head or deputy head of the government entity and are organizationally located outside the staff or line management function of the unit under audit. The report also notes that both of these recommendations would be moot if the Board chose to contract with a public accounting firm-which would be independent and could follow either GAAS or GAGAS at the Board's option.

The director disagreed with both recommendations related to independence and audit standards, emphasizing that the Board's comprehensive oversight structure, which concentrates oversight in DRBOPS and includes the financial examination program, has been designed to enhance the Board's oversight effectiveness. The director stated that he will undertake a review to determine whether enhancements can be made to the current reporting relationship to the Board. The director's disagreement with the second recommendation is based on the belief that the Board's own examination standards, adopted from industry standards, are appropriate to conduct fieldwork and reporting. Although we do not dispute these statements, we continue to believe that the current organizational structure causes their independence to be challenged, and if the program chooses to follow its own standards, we believe this approach should be reflected in its financial examination reports. The director generally concurred with and has already taken action to implement many of the remaining sixteen recommendations. We plan to follow up on each recommendations as part of our regular responsibilities.